FINANCIAL PROBLEMS
OF
THE STATES IN FEDERAL INDIA

BY

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PREFACE.

This essay seeks to explain the financial problems of the Federating States. During the last one hundred and fifty years an intricate network of relationships has grown up between British India and Indian States. A Federation which has for its object the union of these two Indias for their mutual benefit must take account of what has gone before and seek an adjustment of those political and financial problems which have their roots in the past. We cannot write the Federation on a clean slate. The Indian Federation must at best be a compromise, an attempt to reach the greatest measure of agreement on the largest number of subjects consistent on the one side with the interest of the country as a whole and the rights and prerogatives of semi-sovereign states on the other.

The Government of India Bill which is based on the findings of several committees, commissions and conferences has offered a solution of the outstanding problems through the

medium of a Federation. The financial implications of the Bill for the Federating States are worked out in the essay. The clauses of the Bill bearing on Federal Finance have passed through the House of Commons without substantial modifications except for clause 147 which has been amended to meet the Princes' objections.

In the elucidation of the financial problems Mysore has been taken as an illustration. Mysore bulks largely in the essay partly because the writer is familiar with conditions in Mysore and partly because he is struck by the patriotism shown by Mysore in boldly championing the cause of Federation although Federation may entail serious financial liabilities on her. At any rate, it brings no tangible financial gains to her. Mysore typifies the attitude of the States in general. Contrary to opinion in British India, the States are not so much bent on getting what they can out of the Federation as on contributing what they can to the common stock.

The statistics are mainly drawn from the reports of the Nind Committee and the Davidson Committee. The reader is advised to refer

to these reports for an explanation of the methods of dividing income and expenditure under various heads among the Indian States and British India. Wherever possible recent figures or quinquennial averages have been substituted for the Nind Committee's estimates. The apportionment of burdens and benefits, credits and debits for Mysore has been done on a population basis, consumption basis or according to the indices supplied by the Nind Committee, whichever seemed most accurate.

In the preparation of the tables and in the collection of material I have received very valuable assistance from Mr. C. Narasimha Moorty, M.A., Research Scholar, Department of Economics, Mysore University. I have also drawn freely upon his studies on the political and financial relations between the Indian States and British India.

V. L. D'S.

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I.

PRINCIPLES OF FEDERAL FINANCE.

In a Federation there is a division of powers between the Central and Provincial authorities. Certain functions are appropriate to the federal government and certain others to the federating units. A similar distinction is made in regard to the various sources of revenue. The fundamental principle of federal finance would appear to be that the revenue assigned to the central and provincial or state governments should yield the sums needed for the discharge of their functions. A separation of tax resources would ensure independence for the federal bodies in raising and spending revenues. It would also prevent double taxation and overlapping of tax jurisdictions. No authority must raise money which it cannot spend for itself or spend money which it has not raised. The resources so assigned should be not only sufficient for the immediate task in hand but also should be elastic and expansible to meet the growing needs of governments.

It is not possible, however, to guarantee that the revenue allocated for federal and provincial exploitation will yield just the sums needed for the discharge of their functions. Hence there will always be a need for a compromise entailing concurrent jurisdiction in taxation and the use of the "balancing factors" to correct excesses and deficiencies in the federal and state treasuries. The distribution of the proceeds of a given tax among the component parts of the federation, the imposition by the provinces of a supplementary levy on federal taxes or by the federation on provincial taxes, federal subsidies to the provincial governments and provincial contributions to the federal government, all these devices are made use of to correct the inequalities that arise from a rigid segregation of resources.

II.

THE PROBLEM OF INDIAN PROVINCES.

UNDER the Montague-Chelmsford Reforms there was, no doubt, a separation of tax-resources as between the Central Government and the Provinces in India. But the distribution of revenues has brought with it no financial independence to the units. The provinces are allotted land revenue, excise and stamps while customs, income-tax and salt remain with the Centre. The provincial resources, limited and inelastic as they are, are never sufficient to meet any reasonable standard of expenditure while the Centre has an undue share of these heads of revenue which are both productive and responsive to improvement in trade conditions. One may contrast the expanding needs of the provinces with the stationary needs of the Centre, the provincial deficits with the central surpluses. Under the existing system, therefore, the provinces are not sufficiently equipped with the means to finance their nation-building activities. The possible demands on their

purse are many but their resources are scanty and inelastic.

The plan suggested for the allocation of resources in the Government of India Bill is a considerable advance on the existing system. It is calculated to correct some of its obvious inequalities. Thus the Federal Government, at its discretion, will allot to the federating units a share of the yield of the salt duties, excise duties, and export duties. It will also assign to them a prescribed percentage of the most important category of income taxation, namely, the taxation of personal incomes. The yield of the succession duties, stamp duties, terminal taxes and taxes on fares and freights will be entirely made over to the federating units. The Federation will retain the customs and the corporation taxes and it will be empowered to levy for federal purposes a surcharge on the taxes on incomes and also a surcharge on succession duties, stamp duties, terminal taxes and taxes on fares and freights.

That the position of the provinces has improved admits of no doubt. In addition to what the Central Government has surrendered to them they will retain their existing sources

of revenue. Moreover, the deficits of provinces like North-West Frontier, Sind, Bihar and Assam will be made up by federal subsidies, and the peculiar problem of Bengal will be met by the provision that at least half the proceeds of the jute-export duty will be assigned to the producing units. While a much-needed elasticity is given to the provincial revenues, the Federal Government will have to bear the brunt of the cost of the Federation which is estimated at Rs. 1¾ crores, to say nothing of the subvention to deficit provinces which, however, will have to be given even in the absence of a federation. There will be a strain on the finances at the Centre though the strain is not so great as it might appear at first sight, as the assignment of the additional resources to the provinces will largely depend upon the improvement in the financial situation at the Centre.

III.

THE PROBLEM OF INDIAN STATES.

No plan for federal finance can be complete without the inclusion of the Indian States. The Joint Select Committee, therefore, has, on the assumption that they will join the Federation, made proposals to make them partners in federal revenues and sharers of federal responsibilities. The Government of India Bill is framed on these proposals though with some important modifications.

The Indian States cover an area of 712,508 sq. miles with a population of 81 million people or about 2/5ths of the area and 1/5th of the population respectively of India. Politically there are two Indias, British India governed by the Crown, and the Indian States governed by the Princes who acknowledge the suzerainty of the Crown. But economically and culturally India is one unit. The problem of statesmanship is how to hold the two together, British India and the Indian States,

which, though politically separate, are linked together in every other respect.

The term Indian State connotes different meanings to different people, for there is a striking diversity of characteristics—geographical, economic and political. At the one end of the scale there is Hyderabad with an area of 82,700 sq. miles, a population of 14,500,000, a revenue of 8 crores of rupees, and at the other end of the scale, minute holdings amounting to a few acres only or yielding a revenue equal to the annual income of a skilled artisan. There are States which are constitutionally and administratively advanced and there are States autocratic in character and mediæval in atmosphere. In all there are 562 States of which 108 may be regarded as of major importance, 127 of minor importance and 327 are "Estates, Jagirs and others".

Legally an Indian State is a state in India which is under the protection of His Majesty and which acknowledges the supremacy of the British Crown. In 1774 no such State existed in India. But by 1858 Nepal was the only State that did not come within the scope of the definition. In less than a century the status

of the principalities of India changed from one of independence to one of subordination to the British Crown.

The policy of the British Government towards the Indian States brought within the Empire has changed from time to time. Lee Warner divides the policy into three distinct phases, namely, non-intervention in all State matters, subordinate isolation of the States and union and co-operation with the States. The relations of the States with the Paramount Power are regulated by treaties, engagements and sanads supplemented by political practice, usage and sufferance. These treaties have come into being in a haphazard manner in response to political exigencies and the changing needs of an ever-growing Empire. Each occasion was dealt with as it arose and the arrangements made cannot be reduced to a set of formulae. The general position is summed up in the Montague-Chelmsford Report thus: "The States are guaranteed security from without; the Paramount Power acts for them in relation to foreign powers, and it intervenes when the internal peace of their territories is seriously threatened. On the other hand, the States'

relations to foreign powers are those of the Paramount Power; they share the obligation for the common defence; and they are under a general responsibility for the good government and welfare of their territories."

With the unification of the country and with the development of commerce and communications, trade and industry, the conception of paramountcy has been carried beyond the political to the economic sphere. Whenever there was a conflict between the Imperial Government and an Indian State, the conflict was resolved by the Paramount Power more or less on its own terms. Moreover, time and again the States have been vitally affected by Government of India decisions on economic policy taken without reference to them. In the words of the Davidson Committee, "The States remain without the means of guiding or even of effectively influencing policy at the headquarters of Government in regard to many matters in which they have a very direct and material interest. . . . . . It would be rash to affirm that the point of view of the States equally with that of British India has always been in the minds of those who have shaped India's economic policy."

Federation, though the idea has become popular only recently, appears to be a necessary stage in the political evolution of India. The operation of forces, political as well as financial, which are beyond the control of either party, are continually drawing British India and Indian States into a close partnership. Some form of Federation would be the medium through which the parts of India could mutually adjust their differences and co-operate for their mutual benefit. There is no way of settling grievances between the two Indias except by the method of give and take. There is no way of promoting the general good of the whole country of which they are merely parts except by joint deliberation and joint action. During the last 150 years there has grown up a very intricate network of relationships between the two parties and their unravelling and re-adjustment are pre-eminently subjects for a federal treatment.

But the groundwork of a federation in India differs materially from the federations known to history. Elsewhere federation has been the result of agreement between homogeneous units—the constituent elements

surrender some of their powers to a new body. In India the process will be different. For, in the first place, the two parts to the Federation, British India and Indian States, are not politically on the same footing. The provinces of British India instead of surrendering powers to the new body will acquire through a process of devolution powers from the Central Government; the rulers of the Indian States will yield certain of their sovereign functions to the new body. As the Simon Commission pointed out, in India the process of devolution must be combined with the process of integration. In the second place, uniformity is not only wanting as between the provinces and the States but also as between one State and another. The States vary in area, population, wealth, nor do they all stand in the same relation to the Paramount Power. Among them there is no uniformity in respect either of the Imperial burdens they bear or the immunities which they enjoy from Imperial burdens. Some of them in one form or another directly or indirectly make contributions to the central revenues, *e.g.*, tributes, yield of ceded territories, customs, excise, salt, posts and telegraphs, currency and coinage,

maintenance of armies available for Imperial defence. Others, in varying measure, under one head or more, have, through their treaties, engagements and sanads, been free from making contributions to the national exchequer. Even among the contributing States the incidence is arbitrary and unequal. On the whole, neither burdens nor benefits, contributions nor immunities, credits nor debits are evenly or justly apportioned among the States. These claims and counter-claims are not of the same order of magnitude.

In any financial settlement between the Federal authority and individual States account must be taken on the credits side of the various contributions, direct and indirect, which many States are making to the resources of the Imperial Government and on the debits side of the existing immunities of certain States which are of definite economic value. The question is one of balancing the adequacy of their contributions to the Imperial exchequer against the immunities which they enjoy from Imperial burdens.

Direct contributions consist in the main of (*a*) subsidies or tributes and (*b*) value of

territories ceded in the past in return for guarantee of protection. Among indirect contributions may be mentioned the payments made to the central revenues by the inhabitants of the States in the shape of Imperial customs, excise, posts, currency, railways and so forth. It may also be held that the forces maintained by the States also constitute a contribution in so far as these forces possess an all-India character.

The immunities or privileges at present enjoyed by some States relate mainly to customs and salt, and posts and telegraphs. For instance, several maritime States collect and appropriate sea customs at their own ports. Similarly some States supply salt to their subjects from the local sources of manufacture, others obtain a free grant of salt or a cash compensation in consideration of the fact that they have made over their sources of supply to the Government of India. Likewise in posts and telegraphs, some States enjoy privileges inasmuch as they work their own systems or possess agreements which entitle them to the free carriage of their official correspondence.

It is an essential principle of federation

that all federating units should bear the federal burdens on a uniform and equal basis and that the Federal Government should absorb all revenues from what are declared to be federal subjects. But the States concerned will naturally insist on the one hand that the special contributions with which they have been burdened have no place in the Federation, and on the other they will press for the continuation of their time-honoured and treaty-secured privileges and immunities though such conduct may be repugnant to the idea of a federation.

Unlike the provinces of British India the States cannot be treated as a collective unit or on a uniform basis. They can enter the Federation only by individual and separate agreements. For each State there will be an Instrument of Accession in the framing of which due consideration must be given to the varying factors, historical, economic and financial. The mode of operation as outlined in the recent official publications is that each State should enter the Federation as a separate unit and for each State a financial settlement will be drawn up setting off the credits against the debits. There are some States like Mysore

having mostly credits to their account and others like Travancore having mostly debits or privileges to their account. The general principle as adumbrated by the Joint Select Committee seems to be that the value of any credit or contribution proposed to be remitted should be set off against the debit or immunity in possession of the State and that no remission be made unless the credit exceeds the debit and then only to the extent of the balance.

The following table shows all possible items that could be set forth in a balance sheet:

Credits (*Contributions*).—

1. Tributes.
2. Yield of Ceded Territories.
3. Indian States Forces.
4. Customs.
5. Salt.
6. Excise: Imperial & Provincial.
7. Profits on Currency & Coinage.
8. Posts and Telegraphs.
9. Railways.
10. Miscellaneous.—
    (*a*) Railway lands.
    (*b*) Civil Stations and Cantonments.
    (*c*) Others.

Debits (*Immunities*).—

1. Protection.
2. Imperial Services.
3. Immunities.—
   (*a*) Customs.
   (*b*) Salt.
   (*c*) Currency & Coinage.
   (*d*) Posts & Telegraphs.
   (*e*) Miscellaneous.

The Government of India Bill, based as it is on the various committees connected with the Round Table Conferences, has put a very narrow construction on the theory of contributions and a liberal construction on the theory of immunities. The term "contributions" is made to cover two items only, namely, (1) tributes, and (2) value of territories ceded in the past in return for guarantee of protection. "Privilege or immunity" means any right of a financial character enjoyed under any treaty, agreement or usage. It covers four items, namely, (*a*) the retention of the right to levy sea customs or to produce and sell untaxed salt, (*b*) sums receivable in respect of the surrender of the right to levy internal customs duties or to produce salt or to tax goods in transit, (*c*) privileges in

respect of free carriage of state mails, (*d*) the privileges of entry free from customs duties of goods imported by the sea and transported in bond to the States.

On such an interpretation of "Credits" and "Debits" those States having mainly credits will find that their cash contributions will, under given conditions, be written off but that they will get little or no relief under their non-cash or indirect contributions which may be put down as the price for protection. Those States having mostly debits or immunities will find that their share of the central taxes will be correspondingly diminished, for Section 147 of the Bill states that whenever the Federation makes to a Federated State any distribution of a duty or a tax, the value of the privilege enjoyed by the State shall be set off against the payment. But the merit of the interpretation would seem to be that sooner or later an equality and a uniformity or an approximation thereto will be brought about in the burdens and benefits as between the various States. The Ministers' Committee has declared itself against the principle of setting off immunities against the share of taxes to be assigned to the federating units.

IV.

IMPERIAL BURDENS AND BENEFITS.

WE now proceed to examine the balance sheet of credits and debits in some detail. Each item will first be considered on its own merits and then in its federal setting. The general conclusions drawn under each item will be applied to Mysore conditions.

(*a*) *Subsidy or Tribute.*—There are in India 562 States. A great many of them pay nothing at all by way of tribute to the Government of India. 192 States pay tributes of unequal incidence. At one extreme there is the State of Ranasan which contributes Rs. 3 only and the State of Kashmir just two Kashmir shawls and three romals while at the other extreme there is Mysore with the largest contribution amounting to Rs. 24,50,000 or as much as one-third of the total amount paid by all the States. From 1799 to 1934 a sum of Rs. 33.25 crores has been paid by the Mysore Durbar in the form of subsidy.

The inequity of the tributes lies not merely in the inequality of the payments as between one State and another but also in the unequal

distribution of the rights, concessions and privileges among the various States. Thirty States, the most important among them being Kashmir and Alwar, pay no tributes at all and enjoy immunities of the value of Rs. 33 lakhs. Fourteen States, the most important among them being Bhavanagar, Junagadh, Navanagar, Cochin and Travancore, pay tributes of small amounts—Rs. 19 lakhs in all—but they enjoy considerable immunities—Rs. 186 lakhs. Fourteen other States, the most important among them being Mysore, pay tributes amounting to Rs. 35 lakhs and their immunities are of the total value of Rs. 8 lakhs only.

In origin, the subsidy is the price for protection: it is a payment in lieu of former obligation to supply or maintain troops. Article 2 of the Subsidiary Treaty of Mysore, concluded in 1799, runs as follows: "The Honourable East India Company Bahadoor agrees to maintain and His Highness Maharajah Mysore Krishnaraja Ooodiaver Bahadoor agrees to receive a military force for the defence and security of His Highness's dominions; in consideration of which protection, His Highness engages to pay the annual sum of seven lakhs of star pagodas

(Rs. 24.5 lakhs) to the said East India Company, the said sum to be paid in twelve equal monthly instalments, commencing from the 1st of July, Anno Domini 1799."

The claim of the Mysore State for the abolition of the subsidy is not new; it dates almost from the first imposition of the subsidy. The payment has been accompanied at intervals with protests that it is unequal and inequitable. The appeals frequently made for the abolition of subsidy did not fall on deaf ears. The Imperial Government was slowly getting used to the idea of remission, though it took a long time for them to make any public pronouncement on the reasonableness of Mysore's claim. Thus Lord Reading in 1923, in reply to the representation of the Durbar, announced that though the Government of India was unable to comply with the request for the entire abolition of the subsidy it was open to the Durbar to claim some reduction on the ground that the State paid in tributes and on the maintenance of the army for Imperial defence a sum in excess of 15 per cent. of the gross revenues of the State. Lord Irwin in 1927 remitted in perpetuity Rs. 10.5 lakhs out of the

annual subsidy of Rs. 35 lakhs, because, he said, "there is room in the relations between a Paramount Power and those Rulers who acknowledge its paramountcy for other qualities besides strict justice."

The case for the abolition of the subsidy has been put by the Government of Mysore again and again. To quote from the Dewan's Address to the Representative Assembly, June 1933: "We have effected retrenchments to the extent of half a crore of rupees and find that there is no further scope to make savings for balancing our Budget. With crippled resources and drastic retrenchments, it has become impossible to find money for even the most urgent needs of the administration. But yet we are called upon to pay, year in and year out, a sum of Rs. 24½ lakhs. I should add that this payment is in addition to a heavy contribution which the State makes to the Government of India in the form of customs duties and other similar taxes imposed by that Government. These indirect contributions, I think, fully cover the share of the All-India expenditure that should be met by Mysore under any equitable scheme of Federal Finance.

The levy, therefore, of an annual subsidy in addition, as a direct contribution is wholly unjustifiable."

With the development of the federal idea the problem of the tributes has assumed a new shape. It is now on a fair way to solution, for it has been recognised that in a federation there should be no invidious distinction as between one State and another or as between a State and a Province. All the Committees appointed by the Round Table Conferences have, with one voice, as it were, emphasised the necessity of removing the inequalities between the component parts of the Federation. Thus the Peel Committee on Federal Finance has laid down that "there is, generally speaking, no place for contributions of a feudal nature like tributes under the new Federal Constitution." So also the Davidson Committee, "Contributions to the Paramount Power by some of the States under its suzerainty may no doubt have had a historical justification; but as between the members of a Federation such payments by some units for the benefit of all has no logical basis."

The general agreement that subsidies must be abolished is due in no small measure to the

powerful advocacy of Sir Mirza M. Ismail who, finding that the efforts of his predecessors-in-office and his own were not meeting with tangible success, raised the issue of the subsidy to the front rank in the deliberations of the Round Table Conference. Sir Samuel Hoare in his Evidence before the Joint Committee, in answer to Sir Mirza's interrogation, answered thus: "Mr. Chairman, Sir Mirza Ismail has been a consistent and a most effective advocate of the abolition of these tributes. So effective and persuasive has he been that I think we have all of us almost unanimously agreed with him from the very start that he made upon this question two or three years ago. I should very much have liked to have been able to move in the direction of extinguishing these tributes. The trouble has been nothing more than the financial situation; there has been no money available; and we have not been able to take a step that we definitely wished to take in the direction of extinguishing altogether tributes that we think should form no place in Federal Finance. His Majesty's Government accept the recommendation in paragraph 90 of the Davidson Report that, with the advent of Federation, the

cash contributions should be gradually wiped out over a period of years."

That the tributes will ultimately disappear is now beyond question. But what is not so clear is the specific date on which Mysore will be relieved of the burden. The Government of India Bill is vague on the subject. Section 144 states that His Majesty, if he thinks fit so to do, may remit at any time the whole or any part of the cash contributions. Section 145 prescribes the conditions for the remission if His Majesty does not exercise his right. In the first place it states that the subsidy may be remitted over a period not exceeding 20 years from the date of accession of the State to the Federation, and in the second place it states that no such remission will be made until the Provinces have begun to receive moneys relating to taxes on income. There is also the provision that no contribution shall be remitted except in so far as it exceeds the value of any privilege or immunity enjoyed by the State. But considering that the suggestion of the Federal Finance Committee, subsequently accepted by the Davidson Committee, that the sum by which any contribution is in excess of 5%

of the total revenues of the State should be remitted immediately and unconditionally did not find favour with the Secretary of State, it is hardly likely that the subsidy will be fully remitted in the near future. The emergency surcharges, the salary cuts and the deficits in the Provinces were put forward as sufficient reasons why the 5% rule could not be put into operation.

(*b*) *Customs.*—Customs is by far the most important of the revenues of the Government of India. In the year 1933–34, out of the tax revenue of Rs. 75 crores customs alone accounted for Rs. 50 crores. For purposes of tariff the whole of India—British India and Indian States—barring a few exceptions is one territory. The subjects of the States as consumers are importers of foreign goods and as producers are exporters of raw produce. Therefore, the burden of the import duties and export duties partly falls on them. The share of the States in the customs revenue of the Imperial Government cannot be correctly determined as there are no accurate statistics relating to the value or revenue of the goods imported into and exported from each State. The Nind

Committee has estimated the net share of the States at 14% of the net amount of customs revenue.

The claim of the States for a portion of the customs revenue is insistent and like most claims anti-dates the origin of the idea of Federation. The Princes maintain that the British Government, by its customs, imposes an indirect tax on the subjects of the States, thus ignoring a fundamental principle of taxation, namely, that revenue derived from any source is due to the Government whose subjects pay it. Moreover, in the past the British Government has persuaded them to abolish transit duties in their own States on the ground that they are injurious to the trade of India as a whole, an argument which can now be turned against the imposition of the customs duties which, with reference to goods imported into the Indian States, have the force of transit duties. Further every country has, from its geographical position, the right to impose customs at its frontier, a right which has been conceded by the British Government in the case of some States. Thus separate conventions or agreements have been made with maritime,

frontier and inland States like Travancore, Cochin, Baroda, the leading States of Kathiawar, Kashmir and Hyderabad whereby they realise a customs revenue of about Rs. 4½ crores. The Butler Committee, while deciding that customs should be a central head of revenue, was not unmindful of the hardships caused to the States by the Imperial Customs, for in the yield of the duties the States as a body do not participate and in the making of the customs policy the States are not consulted. They say, "We consider, however, that the States have a strong claim to some relief. So long as the maritime customs were on a low level (about 5% *ad valorem*) there was no substantial grievance. But in the year 1921–22, the maritime customs were greatly raised under many heads, and later on a policy of discriminating protection was adopted in British India, with the result that the revenue from maritime customs rose from some five to fifty crores of rupees."

The conversion of a unitary State like India into a federation made up of British India as well as Indian States puts a different complexion altogether on the problem of the

customs. It is the essential part of a federal scheme that there shall be a unified system of customs duties in the interests of economy and efficiency—uniform in the scales of charge on each commodity and in the method of collection, and what is still more important that the revenue realised from customs duties should be allotted to federal needs. The claim of the States, therefore, for a share of the customs revenue loses its validity, for as parts of a federation they must contribute to the federal expenditure out of which they collectively will derive benefits. Moreover, instead of being subjected to the payment of customs determined by an outside authority over whom they have no influence, the States will have a right in the determination of the commercial policy of the country.

The problem of the customs has now assumed a federal aspect. In respect of customs some States like Mysore have no immunity whatsoever while others, Travancore, Cochin, Janjira, Baroda, Bhavanagar, Cambay, Cutch, Junagadh, Mongrol, Morvi, Navanagar, Porbandar, Savantwadi and Kashmir enjoy varying measures of privilege.

In an ideal federation these States would have to relinquish, of their own free will of course, their existing rights. The Davidson Committee has estimated the financial importance of the immunity enjoyed by the States from contribution to central customs revenue: Rs. 182 lakhs out of which Cochin and Travancore are responsible for 13 lakhs each, Kashmir 25 and Bhavanagar 51.

The federal solution to the problems connected with customs is set forth in the Report of the Joint Select Committee. In the first place, there are States like Mysore which at present impose no customs duties on their frontier but which claim a share in the Imperial revenue. "With their entry into the Federation," says the Joint Committee, "the States will take part in the determination of the Indian Tariff, and their claim to a separate share in the proceeds disappears." One is at a loss to follow the reasoning of the Joint Committee. The States have claimed in the first place a voice in the determination of tariff policy and secondly a share in the proceeds of customs duties. With their entry into the federation they will gain the former but not the latter nor

any compensation for the loss in the direction of, say, the removal of the subsidy. For the States' demand for a portion of the increasing yield of customs revenue the official reply is the increasing cost of defence services. Sir Walter Layton in his memorandum to the Simon Commission stated that the total customs and excise revenue of the Central Government has risen from 10 crores before the war to 50 crores in the current year while the cost of the army has risen from 30 to 55 crores. The point of view of individual States is that their contributions towards defence expenditure from various sources, among which customs is one, must not exceed what is strictly due from them.

In the second place, there are States imposing customs barriers on their land frontiers, that is, on goods entering the States from the surrounding parts of India. Internal customs barriers are inconsistent with the freedom of exchange of a fully developed federation, and at the same time it is impossible to deprive States of revenue upon which they depend for balancing their budgets. But in any case the accession of a State to the Federation should imply the acceptance of the principle of free

interchange and the powers entrusted to the Governor-General should be brought to bear upon the State which imposes formidable barriers for internal trade. Under existing conditions, the inhabitants of those States are subjected to double taxation, namely, the sea customs paid at the British frontier and the land customs paid on their own.

In the third place, there are States which possess the right to levy sea customs. The general principle for such maritime States is that they shall be allowed to retain only so much of the customs duties as is properly attributable to dutiable goods consumed in their own States; but treaty rights preclude the carrying out of the general principle. The question will have to be seriously considered whether the States insisting on treaty rights and not agreeing to adjustments and modifications should properly be admitted to the federal system.

We may now examine the claim of Mysore for a part of the proceeds of the customs revenue. When the Government of India assumed the administration of Mysore in 1831 customs and excise duties—"Sayer"—were being collected on as many as 537 articles.

Thereby the interests of trade and industry were seriously jeopardised. As a result of the reforms introduced by Sir Mark Cubbon, taxation under 517 heads was struck off and taxation under the remaining heads was systematised. In the year 1858–59 the yield from customs revenue was Rs. 9½ lakhs.

The Government of India on a number of occasions instructed the British Commissioners in Mysore to reduce the customs duties still further in the interests of the general trade of the country. In 1864 Mr. Lewis Bowring, the then Commissioner, pointed out to the Government of India that the revenue derived from "sayer" was one-tenth of the whole revenue of the State and that it could not afford to forego so large a slice of its revenue. He also wrote, "An inland country like Mysore having no sea board appears to me to be in the same category as regards its frontier duties as Bavaria or Switzerland and to possess as good a claim to levy them as a territory possessing a coast line to realise customs at its ports. . . It appears to me only just that if Mysore or any other inlying Native State is required by the Paramount Power to surrender its frontier or transit duties

it should receive compensation for doing so from the British Government." All the same by an order of the Government of India customs duties were abolished in Mysore in 1865 and no compensation was given to the State for the loss of revenue. It is a point to consider whether Mysore has the right of levying customs duties. At any rate there is no provision in the treaties which expressly prohibits the levy of customs.

The total net share of the Indian States in the customs receipts of the Government of India on an average amounts to Rs. 599 lakhs. On the basis of consumption the contribution of Mysore to Imperial customs comes to about Rs. 97 lakhs. The burden of customs duties on Mysore and other States is sought to be justified on the ground that it is a payment towards the cost of defence. It is contended that Mysore pays for protection directly (subsidy) and indirectly (customs, excise, etc.) a sum far in excess of what she ought to pay. If the exigencies of federal finance require that customs should be a central head of revenue Mysore may be given relief under subsidy. If the Government of India should insist on its

pound of flesh—all the direct and indirect payments—it may well be that the federal benefits will fall short of the federal burdens accruing to the Mysore State, just as at present the credit side of the balance is more heavily loaded than the debit side.

(*c*) *Salt.*—While the heavy incidence of customs revenue has been felt by the people of the States only in recent years, their grievances regarding the production and taxation of salt are at least half a century old. Right from the beginning of their regime the British Government decided to create a salt monopoly for purposes of revenue. But they experienced very great difficulty in the taxation of salt inasmuch as many Indian States possessed and operated their own salt works and placed their surplus stocks on the British Indian market. The British Government, therefore, entered into treaties and engagements with the States with a view to the suppression or prohibition of the production of salt within their territories. Many States have lost their right to produce their own salt or the right could be exercised subject to various restrictions. The States have thus lost their salt revenue to the

Government of India. The Nind Committee estimated that in 1928–29 the net amount of salt on which duty should be credited to the States amounts to 88,96,145 maunds and the share of the States in the salt revenue of India amounts to Rs. 1.11 crores out of a total of Rs. 5.94 crores.

Since the duty on salt is assigned to the federal revenues it follows that all the constituent parts of the Federation should subscribe in the measure of their consumption of salt. But there are several States which under existing salt arrangements are exempt from contributing to central revenues. They may be said to be in the enjoyment of an immunity. The immunity takes the form of a supply of duty-free salt to the State in question or a cash compensation for the surrender of the right to manufacture salt, or the acknowledgment of the right to produce its own salt. Travancore, for example, by virtue of its own production and by its privilege of importing all the salt required by it duty-free, enjoys complete immunity from the payment of the British India Salt Tax—an immunity valued at Rs. 20 lakhs per year. The salt immunities of the States have been calculated by the Davidson Committee at Rs. 46 lakhs.

By Article 18 of the Instrument of Transfer of 1881, Mysore is required to comply with the wishes of the Governor-General in Council in the matter of prohibiting or limiting the manufacture of salt. Earth salt can be produced in Mysore and the question of abolishing or restricting such production was discussed between 1873–1879. The action eventually taken was (*a*) restriction of production, and (*b*) prohibition of export. No cash compensation was offered or asked for. The Davidson Committee has reckoned the value of the immunity at Rs. 1,563 which is equal to the average annual revenue derived by the State from this source.

The production of salt in Mysore is negligible. She depends almost entirely upon the imports of sea salt, about 1,477,000 maunds per year. At the current rate of salt duty, *viz.*, Re. 1-4-0 a maund, the contribution of Mysore to the Imperial revenues amounts to Rs. 18.5 lakhs.

(*d*) *Excise.*—The Government of India raised a considerable amount of revenue by excise. Till 1926 the excise duty on cotton fetched several crores of rupees; duties are

now levied on petrol, kerosene oil and silver, on matches and sugar; the excise on tobacco is looming in the distance.

India derives on an average a sum of Rs. 560 lakhs from the taxation of petrol, kerosene oil and silver, to which the Indian States in so far as they are users of those articles make a contribution. The proportion of the States' share has been determined by the Nind Committee taking into consideration population and consumption per head. Thus they allot 15% of the petrol duty to the States, 22% of the kerosene duty and 22% of the silver duty. Applying these ratios to the excise revenue of the Government of India for the quinquennium ending 1933–34 the share of the States is as follows:—

	Petrol.	Kerosene.	Silver.
India ..	3,44,80,000	2,10,00,000	5,10,000
States ..	51,72,000	48,00,000	1,15,000
Mysore..	4,45,000	4,16,000	10,000

Thus out of a total of Rs. 560 lakhs realised from the duties on petrol, kerosene and silver the share of the States amounts to a little over Rs. 100 lakhs and that of Mysore alone is

Rs. 8.71 lakhs. A refund of Rs. 2 lakhs from the petrol duty is made to Mysore, earmarked for trunk roads.

Excises are instances in which uniformity in the rate of tax makes central administration essential, but the yield may be assigned among the component parts. In the Government of India Bill the power to impose and collect the Imperial excises is vested solely in the Federation, and if the Federal Legislature so provides, the whole or part of the proceeds may be assigned to the Provinces and those States which have joined the Federation. Under the existing conditions Mysore obtains no share of the excise on kerosene and silver but she benefits from the Imperial excise on petrol, matches and sugar. Under the new dispensation Mysore State will surrender her excise revenue on articles such as matches and sugar to the Centre, but should the Federal Legislature so decide, she, along with the other units, may get a share of the proceeds of federal excises.

(*e*) *Coinage and Currency.*—At one time mints in India were as numerous as the dynasties. There was a bewildering variety of coinage which led to much confusion

and inconvenience. Though some degree of uniformity was achieved in the Moghul period the mints sprang up again with the disruption of the Moghul Empire. The British Government set itself the task of placing the monetary system of the country on a uniform basis. After the assumption of paramountcy by the Crown the process of the economic unification of India proceeded apace and among other things, State after State was compelled to abolish the separate currencies. To quote from the Report of the Butler Committee, "There are few subjects on which the States feel more strongly than in regard to mints and currency. In the course of the last half century much pressure has been brought to bear upon States, especially during minorities, to close their mints and to accept the Imperial currency." In the publication of the Chamber of Princes, "British Crown and Indian States," the point of view of the States is stated thus: "The right of coinage is one of the dearest privileges of sovereignty and it was with great reluctance that the various Princes gave up their mints." Certain States, however, still retain their own mints and their own currencies, and others who

had given up the right only for a limited period seek to re-open their mints on the expiry of the term. But on the whole, it may be said that at the present time the currency needs of India are almost entirely met by the coins and notes issued by the Government of India.

Nevertheless the attitude of the States, those who have given up the rights of coinage and those who still exercise the right, has a close bearing on Federation: the former have to forego their claim to a proportionate share in the profits of coinage and currency accruing to the Government of India and the latter should consider themselves as being in possession of an immunity or a privilege which, in so far as it is not shared by all, constitutes an encroachment on the federal principle of equal benefits and equal responsibilities. These two may be considered one by one.

In the first place, the claim of the States to participate in the profits of coinage and currency is under existing conditions well founded. The Federal Finance Committee have included in their forecast of federal revenues an annual income of Rs. 380 lakhs, an income to which

the Indian States make a substantial contribution in so far as the coins and notes of the Government of India circulate in their territories. The value of the share of the States, on a population basis, amounts to about Rs. 72 lakhs. But the claim of the States, though justifiable in unitary India, is not tenable in federal India. For obviously coinage and currency is a federal subject and any profits thereon should accrue to the Federal Government and all that the States have a right to is the opportunity of exercising their due share of influence in the monetary policy of the Federation.

In the second place, the privileges enjoyed by a few States in the issue of their own currency raises a difficult question. It is most desirable that a uniform federal currency should circulate throughout the Federation. If uniformity cannot be achieved in the issue of currency an equality of treatment in a federal spirit can be achieved by taking away the right from those States which now exercise it or by debiting their account with the value of the right. The States which at present issue their own coinage are twenty in number: in many the right is limited to the minting of coins of low

value or of coins which are meant for ceremonial purposes only; in seven States only the local currency is of real monetary importance and out of these it is only in Hyderabad that it is a source of considerable profit. On account of the negligible place that most of these currencies occupy in the circulation of the country as a whole the Davidson Committee thinks it not worth while to consider the right as an immunity or to suggest the buying up of the right at the cost of the federal revenues. Hyderabad, however, stands in a class by itself. Its coinage and currency is a source of considerable profit to itself and the value of the immunity, that is, loss to the federal revenues, is estimated at Rs. 17 lakhs.

Mysore will be called upon to give up its claim to a share of the profits in Imperial coinage and currency on the ground that it is a federal subject to be administered in the interests of the whole country. The history of Mysore currency is interesting. In the days of Hyder Ali and Tippu Sultan, Mysore minted its own gold and silver coins. During the reign of Tippu Sultan there were four varieties of gold coins and seven varieties of silver coins,

some of them admitted by historians to be of a most attractive design. In the days of the Hindu dynasty which was restored to the Mysore throne after the fall of Tippu, the standard coin of the realm was the Kantiraya Varaha (Rs. 2-14-8). During the Commission Rule, in 1853 to be precise, it was replaced by the rupee. In November 1870 the Indian Coinage Act was extended to the territories of Mysore and the coins of the Government of India became legal tender in the State. By Article 13 of the Instrument of Transfer, 1881, it was agreed that "the separate coinage of the Mysore State which has long been discontinued should not be revived." Mysore uses the currency of British India and in so doing makes a contribution to the revenues of the Imperial Government. On the basis of population the share of Mysore in the currency profits of the Government of India (Rs. 380 lakhs) may be set down as Rs. 7 lakhs. In the larger interests of the Federation Mysore like all other States may not press her claim for a proportionate share, but in the long list of her contributions to the central revenues these profits will have their due place.

(*f*) *Posts and Telegraphs.*—Imperial Post illustrates the tendency of the Paramount Power to push its jurisdiction in the interests of uniformity over territories not strictly falling within its domain. As Panikkar says, "Policy tends unavoidably towards the extension of the sovereign rights of the Paramount Power. . . . . It cannot be denied that these extensions of rights, though they are counter to the sovereignty of the States and amount in cases to an encroachment, have been made in the interests of Indian unification, especially in the matter of defence." In India there was a multiplicity of postal systems but barring Mysore, Travancore and Cochin these were not well administered. To remove the complexity and the inefficiency of the existing arrangements the Government of India replaced, wherever possible, the local postal systems by the Imperial system. To-day the great majority of the Indian States are served by the Imperial Post. In fifteen States, however, the Durbars provide their own postal service. Among these, five States (Gwalior, Chamba, Jind, Nabha and Patiala) have conventions with the Imperial Post Office and their stamps are valid for

correspondence to any part of India; ten States (Hyderabad, Cochin, Travancore, Jaipur, Charkhari, Junagad, Krishnagad, Mewar, Shahpura and Orchha) have British and State postal systems existing side by side, the former mainly concerned with correspondence across the State frontiers and the latter with the correspondence within the State. The State postage stamps of the convention States are valid for correspondence to any part of India while the stamps of the non-convention States are not valid outside their respective territories.

The States which have joined the Imperial Postal System have put forward certain grievances. They believe that Posts and Telegraphs are a source of profit to the Government of India and that inasmuch as the operations of the department are carried on in State territory a proportionate share of the profits should be handed over to them. The truth is that far from there being any profits there is a loss on the working of the Department. Even if profits were made, they should be devoted to the reduction of capital charges and improvement of the service. Several States object to the opening of the Savings Bank in their post

offices as these compete with their own institutions and unduly restrict their ability to raise loans from their own subjects. The Government of India justify the banking operations of the Department on the ground that they promote thrift and encourage investment. Moreover, the attraction of the Post Office is undoubtedly due to the credit of the British Government. They are unable to admit the existence of any profits which the States are entitled to share and they are prepared to arrange for the complete cessation of their banking operations in the territory of any State which definitely asks for it.

Under the new dispensation Posts and Telegraphs will become a federal subject. The existence of a number of postal systems in India is a hindrance to the realisation of the federal ideal. In the interests of postal unity the States which have their own postal systems should merge them in the Federal Posts and Telegraphs Department. The States, however, are not prepared to surrender their privileges because their post offices, they say, unlike the Imperial concern, yield them a considerable revenue which they cannot afford to

forego. But the States which do not possess their own postal systems regard as invidious the enjoyment by a few States of a privilege which has been denied to them. In a Federation at least they do not want to be discriminated against. In their opinion it is but right that the cash value of postal privileges and immunities should be assessed and charged to the debit of the Federating States. The Davidson Committee, however, thinks that the maintenance of postal systems by certain States constitutes a privilege of a political and sentimental nature rather than an immunity to which a cash value can be attached.

The postal immunities are of several sorts: maintenance by the States of their own postal departments; free grants of stamps for official correspondence; free carriage of official correspondence; privileges in respect of obtaining a share of the receipts of the Telegraph Department.

The impact of the Federation on Mysore is that the postal immunity will have to be accounted for in the settlement of credits and debits. As early as the seventeenth century, in the reign of Chikka Devaraja Wodeyar, an

efficient postal system called "Anche" was established in Mysore. The "Anche", however, was more than a postal service; it was an agency of the police. As Wilks, the author of the *History of Mysore,* says, "It was not only as in England the passive instrument for conveying intelligence, but the actual agent for obtaining it. The Post Masters at the several stations were, in addition to their passive duties, what in the modern vocabulary of Europe would be named confidential agents of police." In 1885 negotiations were set on foot for the amalgamation of the "Anche" with the Imperial Postal Department. In 1889 Mysore was incorporated in the British Indian System, the price paid for securing unity being the concession that the whole of the official correspondence of the State should be carried within the State limits free of cost and through British territory at the reduced rates allowed to the official correspondence of the Imperial Government. Previous to the amalgamation the Mysore "Anche" was worked at an annual loss of Rs. 65,000, but the loss must be set against the free carriage of government mail, the cost of which is reckoned at 1¼ lakhs of rupees.

One might say that there was a considerable surplus on the working of the indigenous system. The Davidson Committee have estimated the value to the Mysore Durbar of the postal immunity resulting from the free carriage of official correspondence: if the articles now carried free for the State were paid for at the British Indian rates, the revenue accruing therefrom to the Department would be Rs. 5,57,700. But the Davidson Committee have not attached sufficient importance to the consideration that if Mysore worked its own postal system she would have made a profit as she did before amalgamation and other States do even now and that the rates at which it could carry the mail would be lower than the British Indian rates. Rather than pay an immunity so obviously over-valued it would be worth while to buy service stamps for Government letters.

One might go further and ask whether Mysore is really in possession of any privilege which might be construed as being an immunity. If there were any immunity at all it would arise out of the terms by which the State accepted postal unity. But the terms preclude the idea

of a concession or a privilege, for the Imperial Postal Department agreed to carry without charge the whole official correspondence provided that the Mysore Durbar made over to it the entire control and management of the postal arrangements in the State. The free carriage of official mail is not an immunity but simply a *quid pro quo* for having surrendered the Mysore postal system which was a source of gain to the State.

The Davidson Committee's argument is a little difficult to follow. They suppose that if a State retains its own postal system it is not in possession of any immunity which has to be accounted for; it is simply a "sentimental privilege" which has no cash value. If, on the other hand, the State has surrendered its postal system in exchange for an undertaking that the official correspondence should be carried free of charge, then it is in possession of an immunity to which a definite cash value must be attached. Under these circumstances it would be to the advantage of Mysore to ask for the restoration of the "Anche" system.

(*g*) *Price of Protection: Defence.*— It stands to reason that the States should

bear their due share of Defence Expenditure. Under the heads Army, Marine, Military Works and Loss on Strategic Railways, the Government of India incurs an average expenditure of Rs. 56,79,33,281, out of which the army alone is responsible for Rs. 50,39,00,000. Leaving out the share of Burma, Rs. 1.2 crores, and adding the total "effective" military expenditure of the States, Rs. 2,38,71,000, the net expenditure stands at Rs. 57,98,04,281.

In order to discover the proper share of the States in the Defence Expenditure the Nind Committee was required to classify separately expenditure on (*a*) external defence, and (*b*) internal security. After consultation with the Army authorities it came to the conclusion that it is impossible to differentiate the sums spent on purposes of external defence from those spent on purposes of internal security. Under these circumstances the financial responsibility of British India and Indian States can best be assessed by dividing the military budget between the two according to their respective populations. The share of the States will work out to Rs. 13,21,95,380.

The term "effective" military expenditure

requires to be explained. The States maintain their own forces but there is no criterion for deciding their effectiveness and eligibility for active service. Most of the States, however, have joined the Reorganisation Scheme, the principal exceptions being Travancore, Cochin, Baroda and Kolhapur. Again certain States which wholly or partially have come under the Reorganisation Scheme incur military expenditure on Bodyguard, Household Cavalry, Armed Police, State Band and so on. The Nind Committee has divided the expenditure of the States on their own armies under two heads, (1) Indian States Forces, and (2) Other Military Expenditure. It has taken the charges incurred on the former as "effective" military expenditure and it has left the latter out of the estimate.

The Indian States, therefore, have to pay directly or indirectly a bill of Rs. 13.21 crores towards the defence expenditure. 2.38 crores may be credited to them on account of the forces maintained by them on a level of British efficiency. Moreover, many States have been making as a part of the price for protection cash contributions to the Imperial exchequer,

called tributes, of the annual value of Rs. 72 lakhs, while some States *in lieu* of cash contributions have surrendered once for all to the suzerain power parts of their territory, estimated to yield annually a sum of Rs. 37 lakhs. These tributes and cessions roughly of the value of 1 crore of rupees, therefore, represent a share borne by the States in the military expenditure of the Government of India. The Indian States have to make up Rs. 10.83 crores before they could be said to have discharged their responsibilities under Imperial Defence. It is made up in great part by the indirect contributions which the States make in the shape of customs and excise, posts and telegraphs, currency and coinage.

Since the restoration of Mysore to the Hindu dynasty in 1799 the obligation of Protection has been assumed by the Government of India. In return for the defence service rendered by the suzerain power it has been receiving from Mysore not only cash contributions but also considerable sums of money in the form of revenue from indirect taxation such as customs and excise. It is necessary to examine how these direct and indirect

payments, in bulk, stand in relation to the legitimate share of Mysore in the defence expenditure of the Imperial Government. On the basis of population the share of Mysore in the defence expenditure will be about Rs. 114 lakhs. Mysore maintains an army at an average cost of Rs. 19.36 lakhs, out of which a sum of Rs. 9.19 lakhs is taken by the Nind Committee as the "effective" military expenditure, that is, expenditure on the Mysore State Force. The net liability of Mysore in respect of defence will thus stand at Rs. 105 lakhs. Against it the subsidy of 24½ lakhs of rupees must be set down which leaves a balance of Rs. 66½ lakhs. The indirect payments made to the Imperial exchequer through customs alone will cover the balance of the liability and leave a considerable sum to the credit of the State. Or to put the matter in another way, if the subsidy should be written off in full and immediately, the share of Mysore in the defence expenditure of the Government of India will be made up through payments made to the central customs, these payments amounting to about Rs. 97 lakhs per year.

(*h*) *Imperial Services.*—The Government

of India incurs expenditure on various items of public welfare. In the benefits that arise from the expenditure the Indian States participate in varying degrees. Payments for these benefits are not legally binding on the States, because at the time when the treaties were contracted the Government of India strictly abstained from all welfare activities. It is now contended that since the States claim that they have a right for a share in the indirect revenues of the Government of India, British India can claim, with equal justice, that the States should bear their fair share of the Imperial burdens which will presently become Federal burdens.

The Nind Committee which was appointed in 1930 has made a list of all those items of central expenditure which may properly be regarded as constituting Imperial burdens for the States. The principal items are expenses incurred on account of the High Commissioner for India, Agent of the Government of India in South Africa, Port Quarantine measures, Central Agricultural, Veterinary, Medical and Forest Research, Railway Board, Chiefs' Colleges, League of Nations, Foreign and Political Department Secretariat, Consular

representation abroad and in India, North-West Frontier Province, Watch and Ward expenditure, Civil Works, Political Agencies, Aden, and Revenue Collection charges on customs and salt. While the Nind Committee have estimated the monetary equivalent of these burdens at Rs. 846 lakhs they have not determined the share to be debited to the States.

Although the share of the States under each head of the Imperial burdens cannot be accurately reckoned, it is possible on certain empirical assumptions based upon population and the indices provided by the Nind Committee to fix the amounts within limits. The total liability of the States may be thus put at Rs. 263 lakhs. The share of Mysore, working it out item by item, totals up to Rs. 18 lakhs.

V.

FINANCIAL IMPLICATIONS OF STATES' ENTRY.

On the eve of the Federation it behoves the Indian States to take stock of the burdens they bear and the benefits they enjoy through the Imperial connection. The benefits arise from two sources only, namely, protection and the services rendered by certain departments of the Government of India which have an all-India importance. The burdens are of two sorts: direct burdens such as tributes, and yield from Ceded Territories, and indirect burdens, *e.g.*, payments to Imperial customs, salt, excise and profits on currency and coinage. The position may be summarised thus:

Indian States.

Benefits.—

Item.		*Monetary Equivalent.*
1. Protection	..	13,21,95,000
2. Imperial Services	..	2,62,50,000
Total	..	15,84,45,000

Burdens.—

	Item.	*Monetary Equivalent.*
1.	Tributes and Subsidies ..	72,04,000
2.	Yield from Ceded Territories ..	36,97,000
3.	Indian States Forces ..	2,38,71,000
4.	Customs ..	5,98,95,000
5.	Salt ..	1,11,20,000
6.	Excise ..	1,00,87,000
7.	Currency & Coinage ..	72,00,000
	Total ..	12,30,74,000

Thus the benefits exceed the burdens by about Rs. 353 lakhs. The table shows that the impression prevailing in certain circles that the States are paying more than their legitimate share of the Imperial Expenditure is not well-grounded. In the memorandum prepared by the Government of India for the Federal Structure Committee it is stated, "Generally speaking, on behalf of British India, it can be argued that, whatever might be the claims to a favourable adjustment of individual States, the

position hitherto has not been one in which on balance the Indian States have contributed more than what is a fair equivalent for the benefits which they have received, or, in other words, that the taxpayers of British India as a whole have not been relieved at the cost of burdens inequitably imposed upon the States as a whole." An assessment of the value of the burdens and benefits seems to disprove the view that British India gains at the expense of the Indian States. In the publication of the Chamber of Princes, *British Crown and Indian States,* it is stated that while the liability of the States in respect of Imperial defence expenditure is only about Rs. 4 crores, their indirect payments alone to the Imperial Government amount to 10.5 crores. Our estimate shows that the Indian States through their direct and indirect contributions do not fully meet their proper share of Imperial expenditure, although one must admit that there are numerous factors in the situation which cannot be correctly assessed.

The States, however, may take their stand on their own rights and insist that protection is an Imperial responsibility and that, having

surrendered parts of their territory and having been compelled to pay the subsidies and tributes, they are entitled to protection at the hands of the British Government. Their responsibility ends with the cessions of territory and payment of tributes which, in their opinion, is really their price for the protection they receive from the Imperial Government. To be saddled with the enormous expenditure of Rs. 13.21 crores as their share of the Army Budget is to lay upon their shoulders a burden they did not bargain for. It may be fair but not strictly just to call upon the States to make direct and indirect contributions to the Imperial Exchequer and then set down their share of Imperial customs, salt and excise along with tribute and territory as what is owing from them towards the defence expenditure of the Government of India. Moreover, the States maintain their own armies at a cost of Rs. 2.38 crores and these are available for Imperial Defence.

Mysore, like all States, will effect a financial settlement on its entry into the Federation. That her position under existing conditions is none too advantageous is revealed by the following table:—

MYSORE STATE.

Benefits.—

	Item.		*Monetary Equivalent.*
1.	Protection	..	1,14,35,000
2.	Imperial Services	..	17,91,000
	Total	..	1,32,26,000

Burdens.—

	Item.		*Monetary Equivalent.*
1.	Subsidy	..	24,50,000
2.	Mysore State Force	..	9,19,000
3.	Customs	..	97,06,000
4.	Salt	..	18,46,000
5.	Excise	..	8,71,000
6.	Currency & Coinage	..	7,00,000
	Total	..	1,64,92,000

Thus Mysore at present pays to the Imperial Government more than it receives: the excess of the burdens over the benefits is Rs. 32,66,000. Suppose the subsidy were

written off immediately, even then the indirect contribution made by the State in the shape of customs, salt, excise and profits on currency and coinage and maintenance of troops would cover the payment for Protection and for the Imperial Services and leave a balance of Rs. 8,16,000 to the credit of the State.

The entry of the States into the Federation will involve considerable changes in the existing situation. The changes will be on the side of burdens as well as of benefits. We must assess the financial implications of the Federation for the States. A Federal system presupposes a uniformity and an equalisation of burdens and benefits among the constituent units. But the Indian Federation is unique in the sense that there is no homogeneity, no common basis on which the members could adjust their differences. The provinces differ from the States in respect of size, population and wealth, and the States differ among themselves in almost every political, economic and financial respect and in respect of their obligations to the common sovereign.

The Indian States do not enter the Federation on a clean state. There is an intricate

network of relationships, an interpenetration of rights and obligations which must be readjusted in order to conform to a federal polity. Mysore is no exception to the rule. She has been contributing to the revenues of the Government of India directly in the form of an annual subsidy and indirectly in the form of customs revenue, salt revenue, revenue from the Imperial excises on petrol, kerosene, silver and profits from currency and coinage. The Government of India on its part has been rendering a number of services, the most important of which is Protection.

The problem is to discover the net advantage for Mysore in joining the Federation, in other words, to assess on the one side the additional burdens that the Federation may impose on the State, and on the other side, the benefits and reliefs from existing burdens that will result from the Federation. It is not possible to achieve mathematical accuracy in balancing credits and debits, for there are elements in the situation like patriotism and loyalty and the greater glory of a united India which cannot be statistically computed. But looking at the problem from the point of view of accounting,

it is quite possible to assess the various financial implications of joining the Federation.

The principal provisions of the Government of India Bill bearing on Federal Finance, shorn of their legal terminology, may be set down. These provisions are found in Part III, Sections 134–156.

To begin with, the Bill treats of Contributions and Immunities. The Bill lays down that His Majesty may, if he thinks fit so to do, remit at any time the whole or any part of the cash contribution. In case His Majesty does not choose to remit the cash contributions then there is a formula in the Bill for their ultimate abolition, namely, they will be remitted over a period not exceeding 20 years from the date of accession of the State to the Federation, provided that (*a*) no remission shall be made until the Provinces have begun to receive moneys relating to taxes on income, and (*b*) no contribution shall be remitted except in so far as it exceeds the value of any immunity enjoyed by the State. The formula applies *mutatis mutandis* to the payment of the annual value of the ceded territories.

The Mysore subsidy will thus be written

off wholly or in part by His Majesty at his pleasure. Otherwise, it will be remitted entirely within 20 years, (*a*) the rate of remission depending upon the improvement of the central finances which will enable the Federal Government to return the income-tax to the Provinces, and (*b*) the amount of remission depending upon the value of the immunities enjoyed by the State, that is, Rs. 24,50,000 *minus* the postal and salt immunity valued at Rs. 5,59,000 = Rs. 18,91,000.

The Bill next considers the subjects of Federal taxation. Apart from import duties which are definitely assigned to the Federal Fisc, the various taxes are grouped into three classes and each class is dealt with separately.

1. Certain succession duties, stamp duties, terminal taxes and taxes on fares and freights. These duties and taxes shall be levied and collected by the Federation from (*a*) the Provinces, and (*b*) those Federated States within which they are leviable. The proceeds shall, according to the principles defined by an Act of the Federal Legislature, be distributed among the federating units concerned. The

Federal Legislature, however, may, at any time, levy a surcharge for federal purposes.

The financial implication is that the Indian States need not surrender these duties and taxes. If they do, then they will share in the proceeds, but they will make themselves liable to the federal surcharge.

2. Salt duties, excise duties, export duties. These duties shall be levied and collected by the Federation from (*a*) the Provinces, and (*b*) those Federated States to which the Act imposing the duty extends. The yield belongs to the Federal Fisc, but if an Act of the Federal Legislature so provides, the whole or part of the proceeds may be assigned to the federating units concerned. Not less than half the yield of the export duty on jute, however, will be assigned in any case to those units in which jute is grown.

The financial implication is that the Indian States must surrender these duties. There is, however, some likelihood that they may share in the net proceeds.

The statutory recognition of grants to constituent units introduces a much-needed element of elasticity in the existing system,

under which there is no power to devote Central resources to the Local Governments. The Peel Committee urged the principle of sharing out on the ground that it should make the Federal constitution less rigid and more serviceable than the present constitution. Whenever the Federal Government finds that its resources are yielding an apparently permanent surplus, it should be free, as a possible alternative to reduction of taxation, to allocate the surplus proceeds to the constituent units, both States and Provinces. A surplus in the Federal revenues, however, seems a remote contingency, as the Federal Government will, on the one side, make over a great part of the income-tax to the Provinces and, on the other, will undertake additional responsibilities such as the overhead costs of the Federation and the subvention to deficit Provinces. All the same, the rigidity in the existing system is sought to be removed by the provision that it shall be lawful for the Federation to make grants to the units and *vice versa*.

The Government of India Bill, Section 147* enunciates an important principle, said to be

* Since amended. *Vide* Appendix, p. 83.

conceived in a federal spirit, that the value of privileges and immunities enjoyed by individual States should be set off against the share of revenues to be assigned to them from the Federal Fisc. In other words, whenever a distribution of the proceeds of a duty as the excise duty or a tax as the terminal tax has to be made to the Federated States, the value of the immunities enjoyed by any State (unless it is adjusted already) should be set off against the payment and only the balance, if any, made over to the State. The immunities estimated by the Davidson Committee are as follows:—

		Rs.
Customs	..	1,82,42,000
Salt	..	46,06,057
Currency & Coinage	..	17,00,000
Posts & Telegraphs	..	10,27,025
Total	..	2,55,75,082

Thus, roughly speaking, a sum of Rs. 256 lakhs will be withheld by the Federal Government from the share of revenues to be assigned to the States. The Ministers' Committee have taken strong objection to the principle of

balancing the immunities against the refund of taxes and duties. In their view it amounts to a distortion of the federal picture painted by the Joint Select Committee. The Secretary of State, in the White Paper on Indian States issued on 18th March 1935, has admitted that the section constitutes a departure from the scheme outlined in the report of the Joint Select Committee, though he would consider the departure as of secondary importance.

There is at least theoretical justification for the incorporation of the principle of set-off in the Federal constitution, for in an ideal system of Federal Finance, all Federal units should contribute to the Federal resources on a uniform basis, that is to say, once individual States agree to become component parts of the Federation, their treaty rights, in so far as they amount to a diversion of what are *prima facie* the legitimate revenues of the Federal Government, should be considered as immunities. It is but proper that the Federal Government should be re-imbursed and since it is neither possible for the States to give up the rights nor for the Federation to buy up these rights, there should be a provision in the new constitution for

effecting adjustments in respect of any special privilege or immunity of a financial character enjoyed by a State. Such a provision was in fact made in Section 143 of "Proposals for Indian Constitutional Reform" or what is commonly known as the White Paper of 1933.

Under the existing conditions there are some States which make large contributions in cash and in kind to the Central revenues while they are in possession of hardly any immunities. On the other hand, there are States which contribute but little to the Imperial finances while they enjoy considerable immunities. The real problem is to even out these inequalities or at least to narrow the range of differences between one State and another. The solution offered in the Bill consists of remission of contributions on the one side and on the other the offset of the value of immunities against the share of the States from certain Federal revenues. It is of the essence of Federal Finance that as far as possible burdens and benefits should be on a uniform basis. Section 145 of the Government of India Bill which refers to contributions and Section 147 which refers to immunities seek to

equalise the differences between the various States.

3. *Taxes on Income.*—Income-taxes are a most productive and expansible source of income for public authorities. All the three parties to the Federation, the Provinces, the States and the Central Government, are unwilling to surrender the taxes on income. The plan actually proposed in the Bill is a compromise seeking to satisfy all the three parties.

(*a*) Taxes on agricultural income belong to the units.

(*b*) Taxes on the income or capital of companies, or the Corporation Tax as it is called, belongs to the Federal Government. Ten years after the inauguration of the Federation the Corporation Tax shall be extended to the Federated States, but a right is reserved to any of the States to pay in lieu of the tax an equivalent lump sum contribution to the Federal Fisc.

(*c*) Taxes on income derived from Federal sources, *e.g.*, Federal areas or emoluments of Federal officers belong to the Federation.

(*d*) Taxes on income (other than the

above) shall be levied and collected by the Federation in (*a*) the Provinces, and (*b*) those Federated States in which they are leviable. The proceeds belong to the Federation but a prescribed percentage of the proceeds shall be assigned to the Provinces and the Federated States concerned.

The phrase "prescribed percentage" is objected to by the Ministers' Committee, for, in the opinion of the Indian States, at least 50% of the yield of the income-tax should be retained by the Federal Government. The Joint Select Committee expressly provided that the maximum amount refunded to the units should not exceed 50%. The Indian States are naturally apprehensive that a grant of more than 50% of the yield of the income-tax to the units will unduly weaken the Federal Government.

(*e*) The Federal Government may, at any time, levy a surcharge for federal purposes on taxes on income. The surcharge is applicable to the Provinces and all the Federated States. If in any State taxes on income are not leviable by the Federation, then the State shall make an equivalent lump sum contribution.

The Joint Select Committee contemplated the levy of the surcharge only in times of serious financial stress. In reply to the question asked by the Marquess of Salisbury at the sittings of the Joint Select Committee, Sir Samuel Hoare replied that the surcharge was an emergency surcharge, not intended to be used except in times of difficulty when all the other sources open to the Federation have proved insufficient including the suspension of the refund of the income-tax to the Provinces. But the Bill treats the surcharge as if it were a normal feature of Federal taxation, thus making a departure from the agreement reached on previous occasions.

The financial implications are that the Indian States will have to pay (1) the Corporation Tax or its equivalent, (2) the surcharge on the Income-tax. Although the Bill contemplates the possibility of some States surrendering the income-tax to the Federation, the States as a body have made it clear beyond a doubt that they will retain it for three reasons, namely, in the first place, some of the Federal expenditure will be for British Indian purposes only, *e.g.*, subsidies to deficit Provinces;

secondly, the service of part at least of the pre-Federation debt should fall on British India alone; thirdly, a portion of the proceeds of the taxes on income is derived from the subjects of Indian States, *e.g.*, holders of India Government securities and shareholders in British India companies. To check the Federal tendency to encroach upon the resources of the States and Provinces, the Bill makes it obligatory to obtain the prior sanction of the Governor-General for all measures affecting taxation in which the units are interested. Thus, for example, any Bill which proposes a Federal surcharge will require the previous sanction of the Governor-General.

What particular tax or duty among specified taxes and duties in the three groups will be surrendered by the States will, it is presumed, depend upon the general terms on which they agree to enter the Federation. These taxes, as it were, supply a lever by which the inequality of contributions among the States may be corrected, that is to say, States very favourably situated may be prevailed upon to make over specific taxes to the Federal Fisc and although the States in question are entitled to

receive a share of the yield, how much would be returned to them would depend upon the value of their privileges and immunities. Section 147 of the Bill provides that, whenever the Federation makes a payment to a Federated State out of the proceeds of a tax or a duty, the value of any privilege or immunity enjoyed by that State will be set off against the payment. The Mysore State, the immunity of which is only of the value of about Rs. 5.6 lakhs, will stand to gain, whenever the Federal Government decides to apportion the yield of the salt duties, excise duties and export duties.

In terms of actual cost, the Mysore State must be prepared on entry into the Federation to surrender the excises on sugar, matches and tobacco (if levied); to pay the surcharge on income-tax if it should be levied by the Federal Government; and also to continue to pay the subsidy unless His Majesty chooses to write it off. Ten years after the Federation, in addition to the Federal excises, it will have to pay the Federal surcharge on income-tax, if any; it may have to pay the subsidy unless it is written off wholly or partly as a result of the improvement of the

Federal finances, making it possible to return the prescribed amount of income-tax to the Provinces; it will have to pay the Corporation Tax to the Federal Fisc. Twenty years after the Federation, the subsidy will have disappeared altogether and the Mysore State will have to pay the Federal excises, the Federal surcharge on income-tax, if any, and the Corporation Tax. In remitting the subsidy, account will be taken of the immunities enjoyed by the State.

In a word, the financial burden to Mysore depends upon when and how much of the subsidy will be written off, for the revenues of the State being inelastic and inexpansible and all too insufficient to meet the demands of a progressive State, the cost of the Federation in the shape of additional levies, *viz.*, the Federal excises, the surcharge on income-tax and the Corporation Tax can only be met out of the relief obtained through the remission of the subsidy. The financial implications of the entry of Mysore into the Federation are shown in Table I in the Appendix.

VI.

CONCLUSION.

THE incorporation in a Federal polity of a heterogeneous body of Indian States widely differing from one another and from the Provinces of British India, the union of elements each clinging to its individuality and sovereignty and of communities at very different stages of development and culture is a problem of the first magnitude. The authors of the Report on Indian Constitutional Reforms as well as the Indian Statutory Commission envisaged a Federation in which alone units differing so widely as the Provinces and the States can be brought together for common purposes. But they were so impressed with the difficulty of reconciling what seemed to them to be irreconcilable that they treated Federation as a distant goal to which India should march by easy stages. Thanks largely to the statesmanship of Mysore and Hyderabad, Indian Federation has now become practical politics and is rapidly coming into being. It has been

increasingly felt that, owing to the interlocking of British India with Indian States, the intersection of their boundaries and the interaction and interplay of political and economic forces, many questions of policy arise for which there can be only one solution and that the Federal solution.

The irresistible play of economic forces is such that the Indian States and British India must stand or fall together. Railways, steamships and the rapid transmission of news have for many years joined the different parts of India. Geographically, the States may be separated from one another and from British India; politically, they may be distinct from one another and from British India; but economically, they are all bound into one indivisible unit. They are continually faced by economic problems that must be solved in common. If British India, for example, should take a decision on industrial and commercial affairs, it will have a vital effect upon the States and *vice versa*. In such matters as communications and customs, defence and excise, monetary policy and labour regulation, co-operation is becoming essential. The point is

well illustrated by the effect on the States of the adoption in recent years of a high revenue and protective tariff by British India. In doing so, it has imposed indirect taxation to the tune of 5.85 crores on the inhabitants of the States, a species of taxation without representation. In effect it means that one-fifth of the people of India is in economic subordination to the rest.

Federation will be the means by which a reconciliation of the divergent interests of the two Indias may be brought about. It will provide the machinery for joint deliberation and joint action in matters of common concern. But a Federation is much more than an alliance or an association of a number of political communities for certain common purposes only. It is an organic union of the States with a life led in common, with an aim and a purpose transcending the aims and purposes of the Federating Units. Sir Samuel Hoare, in the White Paper on Indian States, has defined the objective of the Indian Federation thus, "His Majesty's Government have never contemplated the Federation of India only as an association in which British India, on the one hand,

and Indian States, on the other, would do no more than act in concert on matters of common concern. From early stages, discussions have centred on the creation of an organic union between the two with the Federal Government and Legislature exercising on behalf of both, the powers vested in them for that purpose."

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APPENDIX.

Extract from Parliamentary Debates.

HOUSE OF COMMONS, Vol. 299, No. 68.

Clause 147 of the Government of India Bill: "Where under the foregoing provisions of this chapter there is made by the Federation to a Federated State any payment or distribution of, or calculated by reference to, the net proceeds of any duty or tax, the value of any privilege or immunity enjoyed by that State which has not been otherwise taken into account shall be set off against the payment or distribution."

Clause 147 of the Bill as amended by the House of Commons: "Where under the foregoing provisions of this chapter there is made by the Federation to a Federated State any payment or distribution of, or calculated by reference to, the net proceeds of any duty or tax, the value of any privilege or immunity enjoyed by that State which has not been otherwise taken into account shall, if and in so far as the Act of the Federal Legislature under which the payment or the distribution is made so provides, be set off against the payment or distribution."

Table I.

Financial Effects of Mysore's Entry into the Federation.

Items	Before Entry	During ten years after Entry	Twenty years after Entry
Tribute	24,50,000	24,50,000 Reduction possible Remission probable.	Nil
Postal Immunity	Nil	..	5,57,700
Surcharge on Income-Tax @ 25%	Nil	4,00,000	4,00,000
Excise on Matches	Nil	5,50,000	5,50,000
,, Sugar	Nil	5,00,000	5,00,000
,, Tobacco	Nil	4,00,000	4,00,000
Corporation Tax	Nil	6,00,000	6,00,000
Cost of administering Federal Subjects	Nil	unascer-tained	unascer-tained

N.B.—(1) A part of the yield of the federal excises may be returned to the Units.

(2) The excise on tobacco is not levied at present. The Federal Government may tap this source in the near future.

(3) The Corporation Tax, according to the Joint Select Committee's findings, will come into existence ten years after the Federation.

(4) The cost of administering the Federal subjects will, in the case of Provinces, be borne by the central revenues but not in the case of the States.

TABLE II.

Area, Population and Revenue in Seven Indian States.

No.	State	Area Sq. miles	Population	Revenue Rs. in lakhs
1	Hyderabad ..	82,698	14,436,148	818 (O.S.)
2	Mysore ..	29,312	6,423,189	352
3	Travancore ..	7,625	5,095,973	241
4	Gwalior ..	25,972	3,523,070	242
5	Kashmir ..	84,471	3,646,243	231
6	Baroda ..	8,164	2,443,007	260
7	Cochin ..	1,480	1,205,016	88

Table III.

Budget Estimates of Revenue and Expenditure of Central and Provincial Governments in 1933–34.

Central Revenue.	Rs. Crores
Customs (net) ..	50.27
Income-tax (net) ..	17.21
Salt (net) ..	7.60
Other taxes (net) ..	0.60
Net tax revenue ..	75.68
Opium (net) ..	0.63
Railways (net) ..	Nil
Currency and Mint (net)	1.11
Payments from States ..	0.74
Total ..	78.16

Central Expenditure.	Rs. Crores
Posts and Telegraphs (net) ..	0.61
Debt :—	
Interest (net) ..	8.97
Reduction of debt ..	6.89
Civil administration (net) ..	8.76
Pensions (net) ..	3.02
Civil Works (net) ..	1.72
Defence Services (net)	46.20
Subvention to N.W.F.P.	1.00
Miscellaneous (net) ..	0.74
Total ..	77.91

Provincial Revenues.	
Land Revenue ..	35.29
Excise ..	14.85
Stamps ..	12.40
Registration ..	1.14
Scheduled taxes ..	0.43
Total tax revenue	64.11
Forests (net) ..	0.69
Irrigation (net) ..	0.49
Miscellaneous ..	11.32
N.W.F.P. Subvention ..	1.00
Total ..	77.61

Provincial Expenditure.	
Land Revenue and General Administration	14.86
Police ..	12.38
Jails and Justice ..	7.66
Debt ..	4.21
Pensions ..	5.08
Education ..	11.80
Medical and Public Health ..	5.23
Agriculture and Industries ..	2.89
Civil Works ..	8.33
Miscellaneous ..	7.34
Total ..	79.78